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The Effect of Corporate Governance on Earnings Management

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Abstract: This study aimed to examine the effect of corporate governance on earnings management. Independent variables used in this study are the proportion of independent board, audit committee, the structure of managerial ownership and institutional ownership structure. The ratio of independent commission was measured to study the percentage of the number in the independent board t o entire board of commissioners in the company. Audit committee in this research do, that was calculated by adding up the audit committee in the company. The managerial ownership structure is measured by the percentage of shares owned by managers of the total shares outstanding. The institutional ownership structure is measured by the percentage of shares owned by the institutions of the total shares outstanding. Earnings management as the dependent variable proxied by discretionary accruals and is calculated by the modified Jones model.

This research was conducted using data from documentation using www.idx.co.id, Indonesian Capital Market Directory (ICMD). The method of analysis used in this study is multiple linear regressions. This study used a sample of manufacturing firms listed on the Indonesia Stock Exchange (IDX) 2013-2016.

The results showed the simultaneous variable proportion of independent board, audit committee, the structure of managerial ownership and institutional ownership structure have a significant effect on earnings management. However, only the precarious balanc e of independent board is a substanti a l effect on earnings management.

Keywords: corporate governance, earnings management, audit committee, institutional ownership structure

INTRODUCTION

Earnings management is an act of company management to manipulate the financial reporting process by increasing or decreasing company profits through accounting method policies (Setiawati & Na'in, 2000), it is done as an aim to gain personal profit. Scott (2000) explains that managers have a strong interest in a set of accounting policy choices. Therefore, a manager can carry out earnings management on the flexibility of selecting existing accounting policies.

The occurrence can cause minimal earnings management practices by company management. So that, suitable corporate governance mechanism is needed in terms of controlling and managing the company (Cao et. al, 2015; Carcello et. al, 1992; Chambers, 1986). Corporate governance is an effort made by all parties with interest in the company to run their business correctly following their respective rights and obligations. Corporate governance also provides a structure that facilitates the determination of the goals of a company, and as a means of determining performance monitoring techniques (Darmawati et. al, 2005; Hay & Cordery, 2018; Larson, 2004). The Indonesian Institute for Corporate Governance (IICG) defines the concept of Corporate Governance as a series of mechanisms to direct and control a company so that the company's operations run according to the expectations of stakeholders (Dwiputrianti, 2011; Rahma et. al, 2016; Reynolds, 2000).

The purpose of this research is to examine the factors that influence earnings management on the variable managerial ownership structure, institutional ownership structure, the existence of independent commissioners and the audit committee structure carried out by the company. This research has expected to provide a conceptual contribution to the development of the earnings management literature.

THEORETICAL STUDY AND HYPOTHESIS DEVELOPMENT

In implementing corporate governance, the agency perspective deserves to be the rationale for this research. In their study, Jensen & Meckling (1976) have developed agency theory. Agency theory is a work contract relation between the principal and the agent, wherein the contractual relationship the principal as the owner and the investor delegates duties to the agent to act according to the wishes of the principal.

Kathleem (1989) and Li et. al (2020) states agency theory uses three assumptions of human nature, namely: (1) humans are generally selfish (self-interested), (2) humans have limited thinking power about future perceptions (bounded rationality), and (3) humans always avoid risk (risk-averse). Based on the assumption of human nature, managers as humans will act opportunistically, namely prioritizing their interests.

The Effect of the Proportion of the Independent Board of Commissioners and Earnings Management

In agency theory, the contractual relationship and delegation of duties have explained fundamentally. It is principal as the owner of the company to the agent as the manager. The principal, as the owner wants the increasing profitability of the capital they invest. In contrast, the management as the agent wants the maximization of their personal economic needs for their performance (Jensen & Meckling, 1976). The existence of these conflicting interests creates agency problems in the company that are difficult to avoid. The manager of the party directly responsible for managing the company, have more detailed information about the conditions in the field of company performance.

In contrast, the principal of the party who gives the manager authority. That does not understand the company's performance. The difference in the completeness quality of information about the company condition between the manager and the principal can cause an imbalance of information, which is often referred to information asymmetry (Merchant & Stede, 2007; Naco et. al, 2010). The existence of this information asymmetry provides an opening for managers to manipulate the performance they do in the components of financial statements for personal gain. That is a moral hazard which is a form of earnings management (Pollitt & Summa, 1998).

Prior research on the impact of the independence of the board of commissioners on earnings management has been carried out. Nasution & Setiawan (2007) found that the variable composition of the independent committee of commissioners has a statistically negative effect on earnings management. Utami & Rahmawati (2008) and Yunus et. al (2020) also examined the impact of the design of the independent board of commissioners on earnings management, and the results of this study indicated a negative relationship between the creation of the independent panel of commissioners and earnings management. And also Yunus. et. al (2020) explains that it has to implament the good stratgis of management system to be impact. Based on the above reviews, the following hypothesis is formulated:

H1: The proportion of independent commissioners harms earnings management.

The Effect of the Audit Committee on Earnings Management

Information asymmetry caused by differences in information between managers as agents and principals about the existing conditions in the company has provided an opportunity for managers to carry out moral hazard by manipulating their performance in the components of financial statements for personal purposes (Cao et. al, 2015; Johari et. al, 2017; Keim & Grant, 2008). It is a form of earnings management. To minimize the formation of fraud committed by managers, That can financial reports they make. It is necessary to have supervision by a third party that is independent of the financial reporting process, namely an independent audit committee (Utami & Rahmawati, 2008; Afifah et. al, 2015).

The audit committee is the party responsible to the board of commissioners to help carry out the duties and functions of the board of commissioners in terms of company accounting policies, internal controls, and financial reporting systems (Siallagan & Machfoedz, 2006). About earnings management, companies that have audit committees can minimize fraud by managers through the supervisory function of the financial reporting system.

Klein (2002) states that companies that have audit committees will hinder management's earnings management behavior. Siregar and Utama (2005) suggest that there is a negative relationship between discretionary accruals and the existence of an audit committee. Nasution & Setiawan (2007) conducted a study to examine the effect of the presence of an audit committee on earnings management which indicates a negative relationship, in which the audit committee can reduce earnings management behavior by the government. Based on the formulation above, the hypothesis can be formulated as follows:

H2: The audit committee has a negative effect on earnings management.

The Effect of Managerial Ownership Structure with Earnings Management

The amount of managerial share ownership in the company will increase the manager's responsibility for their performance because the decisions and implementation of these managers will affect the level of profit and risk they receive personally (Arnold et.al, 2013).

According to Ujiyantho & Pramuka (2007), and Fohrurrozi. et. al (2020) said that the earnings management is mostly determined by the motivation of company managers and also can manage by using IoT as technology. Different reasons will produce different amounts of earnings management, such as between managers who are also shareholders and managers who are not shareholders. These two things will affect earnings direction because the ownership of a manager will determine the policies and decisions on the accounting methods applied to the companies they manage. In general, that a certain percentage of share ownership by management tends to influence earnings management actions. The research results of Ujiyantho & Pramuka (2007) states that managerial ownership has a significant negative effect on earnings management. Based on the description above, the researcher formulates the following hypothesis:

H3: Managerial ownership structure has a negative effect on earnings management.
The Effect of Institutional Ownership Structure with Earnings Management
The difference in interests between the principal as the owner of the company and the agent as the manager of the company creates agency problems that can trigger earnings management. The existence of institutional investors will improve the function of better monitoring of actions taken by the government (Boediono, 2005). That is because institutional investors such as banks, investment companies and ownership by other institutions have a considerable level of investment in the company so that if institutional investors are dissatisfied with the manager's performance of the capital they invested, they will sell their shares to the market. That is what underlies institutional investors to have a more specific monitoring function of management performance, thereby reducing earnings management practices in companies. Institutional investors are said to be sophisticated investors so that they can perform their monitoring function more effectively and are not easily deceived or believe in manipulation by managers such as earnings management actions (Dechow et. al, 1995).
Indriastuti (2012) found that statistical institutional ownership has a negative effect on earnings management in the company. A considerable level of institutional ownership will lead to a tighter supervisory function, to prevent opportunistic manager behavior, which in turn will have an impact on improving operational performance and minimizing effective earnings management practices. Based on the research above, the researcher formulated the following hypothesis:
H4: Institutional ownership structure has a negative effect on earnings management.

METHODOLOGY

The populations in this study are manufacturing companies listed on the Indonesia Stock Exchange. The sample selection of companies in this study used a purposive sampling method, with the following sample criteria: Manufacturing companies listed on the Indonesia Stock Exchange during the period 2013-2016, companies that published financial reports during 2013-2016, companies that had complete data regarding the variables used in the study. The data analysis method used in this research is multiple regression analysis with hypothesis testing as follows:
a. Test the coefficient of determination (R^2)
b. Simultaneous significance test (F statistical test)
c. Partial significance test (T statistical test)
In 2013-2016, 144 companies listed and went public on the IDX. Of the 144 companies, samples were taken by purposive sampling, and then obtained a sample of 17 companies.

RESULTS AND DISCUSSIONS

Results

Determination Coefficient Test Results

Table 1: Koefisien determinate Model Summary[b]

Model	R	R^2	Adjusted R^2	Std Error of Estimate
1	.529[a]	.280	.242	.06757

a. Predictors (Constant), SKI, KA, PDKI, SKM; b. Dependent Variable: DA
Source: Processed secondary data

Table 1 shows that the coefficient of determination (R^2) is 0.242, this means that the ability of the independent variables (the proportion of independent commissioners, audit committee, institutional ownership, and managerial ownership) in explaining the dependent variable (earnings management) is minimal.
The correlation coefficient (R) in Table 1 is 0.529, indicating that the relationship between the independent variable and the dependent variable is vital because it has a correlation coefficient value above 0.52.

Simultaneous Test Results (F Test)

Table 2 shows that the significance value is 0.00, which has a value of less than 0.05. That means that the proportion of independent commissioners, audit committee, institutional ownership, and managerial ownership simultaneously has a significant effect on earnings management. The results of this study are consistent with the results of research conducted by Ujiyantho & Pramuka (2007), in which the variable proportion of the independent board of commissioners, audit committee, institutional ownership, and managerial ownership simultaneously affects earnings management.

Table 2: Anova Test Results

ANOVA[a]

Model	Sum of Squares	df	Mean Square	F	Sig
1 Regression	.133	4	.033	7.296	.000[b]
Residual	.342	75	.005		
Total	.476	79			

a. Dependent Variable: DA; b. Predictors (Constant), SKI, KA, PDKI, SKM;
Source: Processed secondary data

Partial Test Results (T-Test)

Table 3 shows that only the proportion of the board of commissioners has a significant effect on earnings management, with a significance value of 0.000 (<0.05). On the other three variables, audit committee, managerial ownership, and institutional ownership do not have a significant effect on earnings management with a significance value of 0.751 respectively; 0.110; and 0.649 (> 0.05).

Table 3: Partial Test Results (T-Test)

Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.160	.081		-1.973	.053
	PDKI	-.243	.055	.486	4.411	.000
	KA	.005	.015	.038	.319	.751
	SKM	.196	.121	.201	1.620	.110
	SKI	.028	.061	.058	.457	.649

a. Dependent Variable: DA;
Source: Processed secondary data

DISCUSSIONS

The first hypothesis testing states that the proportion of independent commissioners has a negative effect on earnings management. This research shows the result of t count is 4,411 and the value of sig. Amounting to 0,000. Thus it can be concluded that the variable proportion of independent commissioners has a significant effect on earnings management, so the first hypothesis is accepted. That is in line with the research conducted by Utami & Rahmawati (2008) which found that there was a significant adverse effect between the proportion of independent commissioners and earnings management. However, the results of the study are not in line with research conducted by Wahyuningsih (2009), which found that the proportion of independent commissioners does not affect earnings management. The existence of an independent board of commissioners is expected to be able to resolve agency conflicts between the principal and the manager, as well as minimize earnings management actions by managers in exploiting the information asymmetry gap to run effectively.

The second hypothesis testing states that the audit committee has a negative effect on earnings management. This study shows the t count of 0.319 and the sig value equal to 0.751. Thus it can be concluded that the audit committee variable has no adverse effect on earnings management, so the second hypothesis is rejected. The results of this study are consistent with the results of research conducted by Siregar & Utama (2005), but contradictory to the effects of research conducted by Nasution & Setiawan (2007). Several reasons why the audit committee has not been able to suppress earnings management practices is because the appointment of the audit committee is still limited to fulfilling regulations, not intended to enforce Good Corporate Governance practices.

The third hypothesis testing states that managerial ownership structure has a negative effect on earnings management. This study shows the t count of 1.620 and the sig value equal to 0.110. Thus it can be concluded that the managerial ownership variable has no adverse effect on earnings management, so the third hypothesis is rejected. The results of this study are consistent with Boediono (2005) research. However, the results of this study contradict the results of research conducted by Ujiyantho & Pramuka (2007). If seen from the pattern of the relationship between managerial ownership and profit management, it is positive. That means that the higher the level of share ownership by the government, the higher the amount of earnings management on the report (Boediono, 2005).

The fourth hypothesis testing states that institutional ownership structure has a negative effect on earnings management. This study shows t count of 0.457 and a sig amounting to 0.649. Thus it can be concluded that the variable institutional ownership does not have a negative effect on earnings management, so the fourth hypothesis is rejected. The results of the study are in line with research conducted by Wahyuningsih, (2009), which found no influence between institutional ownership and earnings management. However, the results of this study are not in line with the research conducted by Indriastuti (2012) which found a significant adverse effect in which institutional ownership of shares will hamper earnings management practices that occur in companies. These results indicate that institutional ownership of claims has not yet become a mechanism in corporate governance that can improve the tight supervisory function of management performance, to avoid behaviors that can harm the principal by management.

CONCLUSIONS AND RECOMMENDATION

The conclusion that can be drawn from the results of this study is that the independent variable proportion of the independent board of commissioners has a negative effect on earnings management. Meanwhile, the audit committee, managerial ownership structure and institutional ownership structure do not affect earnings management.

This study has limitations, namely the corporate governance variable is represented by the proportion of the independent board of commissioners, the audit committee, the management ownership structure, and the institutional ownership structure. In this study, the characteristics of independent commissioners and audit committees are specifically not included, for example, the competence, expertise and experience of independent commissioners and audit committees, communication with commissioners, directors, internal and external auditors, and other parties as essential aspects of the success of the audit committee's work.

Some recommendations for further research are as follows. First, increasing the research observation period becomes longer so that the effect of corporate governance mechanisms can be felt more in reducing earnings management in the company. Second, adding the sample of companies by not only researching companies in the banking sector. Third, it can add other control variables that are more influential on earnings management, such as profitability and company size. Fourth, using different characteristics of the board of commissioners, such as the competence of the independent panel of commissioners, the frequency of meetings of the board of commissioners, the competence, expertise and educational background of the audit committee, and the experience of independent commissioners.

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